

VZCZCXRO2385
RR RUEHCD RUEHGD RUEHHO RUEHMC RUEHNG RUEHNL RUEHRD RUEHRS RUEHTM
DE RUEHME #3962/01 1991813
ZNY CCCCC ZZH
R 181813Z JUL 06
FM AMEMBASSY MEXICO
TO RUEHC/SECSTATE WASHDC 2199
INFO RUEHXC/ALL US CONSULATES IN MEXICO COLLECTIVE
RUCPDO/DEPT OF COMMERCE WASHDC
RHEBAAA/DEPT OF ENERGY WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHDC

C O N F I D E N T I A L SECTION 01 OF 03 MEXICO 003962

SIPDIS

SIPDIS

FOR WHA/MEX, WHA/EPC, EB/IED
TREASURY FOR IA MEXICO DESK: JASPER HOEK
COMMERCE FOR ITA/MAC/NAFTA: ANDREW RUDMAN
ENERGY FOR KDEUTSCH AND SLADISWAN

E.O. 12958: DECL: 07/18/2016
TAGS: [ECON](#) [EFIN](#) [ENRG](#) [MX](#) [PGOV](#) [PINR](#) [PREL](#)
SUBJECT: MEXICO'S ECONOMIC ACHIEVEMENTS AND CHALLENGES - A
BANK OF MEXICO'S VIEW

Classified By: Economic Minister Counselor Vladimir Sambaiew
for reasons 1.4 (b) and (d)

11. (C) Introduction and Summary. Mexico,s Central Bank Deputy Governor Jose Julian Sidaoui provided a snapshot of the country,s economic situation following the July elections. He said that the surprisingly favorable reaction of Mexican markets, despite political uncertainty, is mainly the result of the current GOM,s ability to maintain fiscal prudence and to make financial stability a priority. Sidaoui stressed that investment in Mexico and overall popular access to credit is increasing because of Bank policies introduced over the last ten years. At the same time, the lack of structural reforms in Mexico is hindering the nation,s competitiveness and hampering competition with China. End summary.

Market Reactions

12. (C) Emincouns and econoffs paid an introductory call on Central Bank Deputy Governor Jose Julian Sidaoui on July 12. Sidaoui opened the meeting noting that for the first time in 30 years the Mexican stock market received capital inflows the day before presidential elections. He noted that the volatility the week after the elections was more the result of external factors such as the close association between the Mexican and U.S. markets, and Federal Reserve Bank statements on inflationary risks and the possibility of interest rate hikes.

13. (C) Sidaoui highlighted that investor confidence increased as a Calderon victory became more likely and generated a market rally. At the same time, he said that experts believe that this rally does not reflect Mexican stock market fundamentals and the market could correct itself in the short term. Sidaoui expects some continued volatility over the coming period.

14. (C) On the positive side, Sidaoui added that a 20-year fixed credit market in Mexico is starting to develop. As markets calmed after the July elections, he said that the yield curve in Mexico flattened but not as much as in the U.S. The reason for this, he said, is the significant long-term interest rate differential between the current U.S. 5.23 percent and Mexico,s 9.49 percent. On a more general note, Sidaoui said that as overall liquidity in the world decreases, the 20-year yield curve becomes steeper.

Outlook on Structural Reforms

15. (C) Like other analysts, Sidaoui emphasized that Mexico,s economic growth is hampered by the lack of structural reforms. Although various reforms are needed, he said that fiscal reform appears to be the most important. Currently, oil revenues fund 40 percent of the federal budget. In addition, Mexico,s weak tax system, especially at the State level, means 95 percent of State expenditures are funded through the federal budget. The results, he said, are State-level permanent expenditures with non-permanent sources of revenue. He used the example of States hiring many full-time permanent employees paid for by petroleum revenues that may well decrease in the future.

16. (C) Pension reform will also be an important priority. Pension liabilities for state employees such as social health institutes, public universities, and municipal employees among others, place significant pressure on public finances, he said.

17. (C) Conversely, Sidaoui highlighted the positive role of private pension funds (Afores). Ten years after being created, they now represent 15 percent of national assets. Additionally, the federal government took a step forward by including these contingent liabilities in GOM books.

18. (C) Sidaoui explained that the passage of structural reforms is likely to encounter obstacles as the National Action Party (PAN) did not win a majority in Congress. Although the Institutional Revolutionary Party (PRI) is likely to be the most willing party to work with the PAN, its

MEXICO 00003962 002 OF 003

support remains uncertain. The PAN will need to build effective alliances with other parties to form a Congressional majority and be able to pass Mexico,s needed reforms.

Mexico,s Sound Economy

19. (SBU) Sidaoui pointed to low inflation rates and the introduction of a beneficial credit system providing fixed interest rates in pesos as triggers for an increase in consumption and for keeping demand up. The Mexican middle class reaps the most benefits, he said, as they are able to obtain flexible loans and mortgages. Sixty-five percent of automobiles and 90 percent of houses sold in Mexico are now purchased through credit, he said. This is a situation vastly different from ten years ago when credit for the middle class was largely unavailable.

110. (C) According to Sidaoui, as a result of a good credit system, a strong fixed investment in machinery and equipment is growing, which is reflected in the recent 20 percent increase in Mexican capital goods imports. Additionally, investment in construction and the public works sector is also strengthening. This year,s first trimester registered an increase of 8.3 percent in this sector compared to the same period last year.

111. (C) Various sectors of the economy are growing thanks to macroeconomic stability reflected in solid financial leadership, stable exchange rate, and low inflation. Sidaoui stated that growth in the agricultural sector was mainly due to NAFTA, and despite some volatility in this sector, there is an upward trend as the first trimester of 2006 registered a 2.6 percent increase in this sector compared to last year. The services sector is registering a growth rate of 5.4 percent for the first trimester of this year, compared to the same period last year. The recent boom in the automobile

sector generated an increase in the industrial sector of 7 percent for the first trimester of 2006, compared to the same period last year.

Economic Challenges

¶12. (C) On the negative side, Sidaoui pointed to Mexico's lack of competitiveness and declining productivity as key factors hampering economic growth. Its inability to compete with China is generating considerable concern among some industries as the labor force is lagging behind in technology. According to Sidaoui, the industrial production index in Mexico is positively correlated with the non-high-tech manufacturing index in the U.S. He saw this link as a reflection of the cost of globalization for Mexico given the lack of structural reforms.

¶13. (C) Another concern, Sidaoui said, is that employment is growing, yet mainly as a result of low-quality employment represented primarily in creation of temporary rather than permanent jobs. In the first five months of this year, temporary employment grew by 20.8 percent compared to the same period last year, whereas permanent employment grew only by 2.2 percent.

Comment

¶14. (C) Virtually all analysts agree that the positive reaction of Mexican markets, despite political ambiguity, is a result of the GOM and Bank of Mexico's combined ability to maintain macroeconomic stability and a low inflation rate. The implementation of a widespread credit system has indeed aided the country's middle class and is increasing consumption. However, without tackling needed economic reforms, Mexico is likely to continue losing competitiveness and productivity, especially in the important higher technology sectors. End Comment.

Visit Mexico City's Classified Web Site at

MEXICO 00003962 003 OF 003

<http://www.state.sgov.gov/p/wha/mexicocity>

GARZA